Equity Compensation and You: How to Tell Your RSUs from your ISOs (and more!)

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Investing has historically been one of the best routes to building long-term wealth. Yet many Americans, around 50%, aren't invested in equity markets outside of their retirement plans. If equity is part of your compensation package, congratulations, you've got a head start!

But just buying and holding stock is not a strategy. How you go about it is super important. Below is an overview of three different types of equity compensation, how to use them strategically as part of your long-term wealth accumulation plan, and how they are taxed.

What do RSUs have to do with it?

Restricted stock units (RSUs) are basically a promise from your employer that entitles you to a specified number of shares of company stock once you meet certain conditions. That's where the restricted aspect comes in. If you don't meet the conditions, you won't receive the equity. Typical conditions are tenure with the firm (usually subject to a vesting schedule), individual or company performance, or a triggering event such as a merger or company sale.

I thought stock options were the Holy Grail!

Stock options give you the *option* to buy company shares at a set price. There are two types of: incentive stock options (ISOs) and non-qualified stock options (NSOs). Both can be very attractive because of the potential for price appreciation. But the thing to remember is they are options, not actual shares of stock.

Options come with restrictions on exercising them and expiration dates. Unlike RSUs which usually have some value, options can and do expire worthless if you don’t or can’t exercise them in time, or if the company’s stock price takes a hit. And in the case of pre-IPO companies, there’s no guarantee there will be public shares before your options expire.

What about ESPPs?

Employee Stock Purchase Plans let you buy company stock, often at a discount. This can be a good deal, especially because some companies’ ESPPs offer discounts of anywhere from 5%-15% off the stock’s trading price. Since you make the purchases with your own money, usually through after-tax payroll deductions, there are no vesting requirements. There are two types of ESPPS: qualified ones, which come with tax advantages, and non-qualified plans. Both allow you to purchase company stock during set offering periods.

How is equity compensation taxed?

The big difference between RSUs, ISOs, NSOs, and ESPPs for tax purposes, is *when* you pay taxes on them and *which* taxes you'll pay.

	RSUs	**ISOs**	**NSOs**	**ESPP**
You pay taxes	When you vest	When you sell	When you exercise	When you sell

For RSUs, once they vest you owe ordinary income taxes on the market value of your shares. The downside is that's true whether or not you sell them right away. When you do sell, you'll owe capital gains tax to the IRS (and potentially the state you're resident in for tax purposes) on any increase in the value of your shares between the RSU vesting date and the date you sold the shares.

ISOs have two great tax benefits.

1. *Timing.* You don't immediately owe taxes once your ISOs vest. You only owe taxes once you exercise them. That gives you flexibility in tax planning.[1]
2. *Tax rate.* As long as you hold onto your options for **a minimum of two years from the date of your grant and one year from the date you sell the shares**, you'll pay federal taxes at low capital gains rates: 10%, 15% or 20%. (You might also owe capital gain taxes at the state level) If you sell

before this minimum holding period is over, you'll have to pay regular income taxes on any gains you made.

NSOs don't have the same tax benefits ISOs do as far as timing or which tax you pay—you'll pay taxes at ordinary income tax rates. But they have an advantage over RSUs because taxes are due when you exercise them, not when you vest.

ESPPs have no immediate tax implications when you buy shares. But when you sell, you will pay capital gains tax if you held onto them for at least the minimum required holding period of 12 months. If not, you'll be taxed at higher income tax rates. You'll also pay income taxes on the difference between the stock price when you bought the shares and the discounted price you paid for them; there's no free lunch!

Other considerations

Working for an employer *and* owning its stock leaves you doubly exposed financially. The potential downside is that you build up too large a position relative to your overall investment portfolio. Too much concentration can be risky for both your portfolio and potentially your net worth. If the company stumbles, you could find yourself simultaneously out of a job and taking a big investment hit.

That's even more of a concern if you also hold employer stock in your 401(k) or other retirement accounts. Still, if you plan well, diversify your investments, and stay disciplined (when necessary) company stock can be an attractive part of your long-term wealth-building strategy.

Lastly, of course it feels great to see the value of your equity jump. But until you've actually sold the shares or converted the options, your wealth exists only on paper. To make sure you're not putting all your eggs in one basket, and to maximize the benefit of any potential gains while minimizing taxes, work with your financial and tax advisors to factor your equity holdings into your long-term investing and financial plans.

1. Depending on your tax bracket and how much you itemize, you might have to pay the alternative minimum tax on your ISOs.